IN THE

Supreme Court of the United States

October Term, 1973
No. 73-641

EDWIN A. and HELEN B. SNOW,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

BRIEF FOR AMICI CURIAE.

CHARLES H. PHILLIPS,
1800 Avenue of the Stars,
Suite 900, Century City,
Los Angeles, Calif. 90067,
Attorney for Amici Curiae.

Of Counsel:
IRELL & MANELLA,
RONALD L. BLANC,
RUDOLPH R. LONCKE.

February 20, 1974.

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

SUBJECT INDEX

TABLE OF AUTHORITIES CITED

IN THE

Supreme Court of the United States

October Term, 1973
No. 73-641

EDWIN A. and HELEN B. SNOW,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

BRIEF FOR AMICI CURIAE.

Statement of the Case.

Section 174[1] provides:

(a) Treatment as Expenses.—

(1) In General.—A Taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

The court below held that expenditures under Section 174 must be related (i) to the development or im-

[1]Int. Rev. Code of 1954. All references to the Internal Revenue Code of 1954 will be made merely by citing the Code Sections. References to other legislation will be specifically noted.

provement of existing products and services, or (ii) to new products and services in connection with a going trade or business. Applying the language of Justice Frankfurter's concurring opinion in *Deputy v. Du Pont*, 308 U.S. 488, 499 (1940), the Sixth Circuit held that for the "new products" aspect of the test, a going trade or business "involves holding oneself out to others as engaged in the selling of goods or services". Since Burns Investment Company, the partnership in issue, did not have existing products or services (it was developing its initial product) and did not engage in selling or licensing activity during the year in issue, the expenditures incurred, admittedly for research and development activities, were not deductible under Section 174.

Question Presented.

Whether a business is entitled to deduct research and experimental expenses incurred in the development of its initial product.

Statement of Interest of Amici Curiae.

This brief is filed by the undersigned attorneys as friends of the Court with the consent of the petitioners and respondent. The question presented in this case is substantially the same for the many newly-organized enterprises engaged in research and development activity prior to the marketing of their initial product. The undersigned attorneys represent various taxpayers and business enterprises engaged in research and development activity who will be affected by the resolution of the issue involved in this case. The undersigned attorneys are also concerned, in their capacity as members of the Bar generally, with the implications of the position advanced by the Commissioner insofar as such

position would tend to foster and perpetuate monopoly and frustrate the development of new inventions and products.

Summary of Argument.

The Sixth Circuit employed an erroneous standard under Section 174 in determining that Burns Investment Company's research and experimentation expenses were nondeductible pre-operating expenses and therefore not incurred in connection with an existing trade or business. The term "trade or business" as used in the Internal Revenue Code must be read in light of the purposes of the particular section which is being construed.

The legislative history of Section 174 indicates that the deductibility of research and development expenditures was intended to benefit small and beginning businesses developing new products and to stimulate the search for new products and inventions. To give effect to the intent of Congress, the term "trade or business" for purposes of Section 174 should be construed to embrace all bona fide business entities organized for a profit motive and engaged systematically and in a sustained manner in research and experimentation directed towards the development of a particular product that is to be marketed.

The Sixth Circuit decision, by requiring a taxpayer who desires to avail himself of the benefits of Section 174, to have engaged in marketing activities in the year in issue, or to have an existing product or product line, improperly imposes restrictions on the normal decisions of small businesses, discriminates in favor of large, established companies, and produces a chilling effect on the development of new ideas.

ARGUMENT.

I.

The Sixth Circuit Employed an Erroneous Standard in Requiring That the Partnership Be Engaged in the Selling of Goods or Services in Order to Be Entitled to the Benefits of Section 174.

The concept of engaging in a trade or business is one that appears frequently in the Internal Revenue Code. See *e.g.* Sections 62, 162, 163, 165, 166(d), 174, 1231. Not only is the determination of whether one is engaged in a trade or business a question of fact, *Higgins v. Commissioner,* 312 U.S. 212 (1941), but the criteria to be applied to make that judgment will vary depending on the purpose of the particular provision under review. A phrase used many places in the Internal Revenue Code, like "trade or business", is not "a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." Mr. Justice Holmes, in *Towne v. Eisner,* 245 U.S. 418, 425 (1918). Thus, for example, because of the special legislative purposes of Section 166(d)(2) (business v. nonbusiness bad debt deduction) the inquiry is to distinguish the broad range of income or profit-producing activities from those which satisfy the narrower category of trade or business. See *Whipple v. Commissioner,* 373 U.S. 193 (1963).

In any case, there is no talismanic formula for what is or is not a trade or business. Actively engaging in marketing activity is only a working tool aiding in the analysis. The purposes and intent behind Section 174 must also be fed into the decisional process to derive

a trade or business test consistent with the objectives of the statute.

Section 174 was intended to be a liberalizing provision to allow expenditures, which otherwise would have to be capitalized, to be deductible in the year incurred. The legislative history of Section 174 indicates a broad purpose to provide an economic incentive, especially for small and beginning businesses, to engage in the search for new products and new inventions. The measure was intially introduced in Congress in 1951 "to clarify the existing confusion in respect of tax treatment of such expenditures, and to prevent tax discrimination between large businesses having continuous programs of research and small or beginning enterprises". 97 Cong. Rec. 4326A (1951) (Extension of Remarks of Representative Camp). The remarks of Mr. Reed of New York, Chairman of the House Committee on Ways and Means addressed to the House during consideration of H.R. 8300, the bill embodying the Internal Revenue Code of 1954, indicates the broad purpose of Section 174 as finally enacted:

> "Research and Development expenditures: Present law contains no statutory provisions dealing with the deduction of these expenses. The result has been confusion and uncertainty. Very often, under present law small businesses which are developing new products and do not have established research departments are not allowed to deduct their expenses despite the fact that the large and well-established competitors can obtain the deduction. . . . This provision will greatly stimulate the search for new products and new inventions upon which the future economic and military strength of Nation depends. It will be particularly valuable to small and growing businesses." 100 Cong. Rec. 3425 (1954).

A small business whose entire energies are devoted to a product development effort would seem to be precisely the kind of company Congress sought to bring within the search of Section 174. The Sixth Circuit's decision is not sensitive to the needs of such a small business because it requires a company to divert its resources in the early stages from research activity to sales and marketing efforts. This kind of requirement interferes with normal business decision-making and subverts Congressional intent "to stimulate the search for new products and new inventions."

The lower courts' reliance on Justice Frankfurter's concurring opinion in *Deputy v. Du Pont,* 308 U.S. 488, 499 (1940), is totally misplaced. The issue in that case was whether the taxpayer's activities to enhance his investment in a corporation constituted carrying on a trade or business under the predecessor section of Section 162. The particular formulation of a trade or business definition in that context cannot be transplanted indiscriminately into Section 174.

Similarly, *Richmond Television Corporation v. Commissioner,* 345 F.2d 901 (4th Cir. 1965), another case under Section 162, is not in point. There, the court held that amounts expended to train prospective employees in the techniques of television broadcasting which were paid prior to obtaining a license to broadcast from the Federal Communications Commission were not deductible. As a matter of law, the taxpayer could not have been in the broadcasting business when the pre-license expenses were incurred. In addition, certain of such amounts, which had been paid to another company, represented "the acquisition of a capital asset whose value to the taxpayer would continue for many years. . . ." 345 F.2d 901, 907. It has long been recognized, as

a general matter, that costs incurred in the acquisition of a capital asset are not deductible but are to be treated as capital expenditures. See *Woodward v. Commissioner*, 397 U.S. 572 (1970). The *Richmond Television* case is consistent with this rule and with those cases which hold that costs to secure a license or franchise, *e.g.*, *KWTX Broadcasting Co. v. Commissioner*, 272 F.2d 406 (5th Cir. 1959) are not deductible but are to be charged to the capital account.

Under Section 174, however, entirely different considerations prevail. The section extends to the taxpayer the privilege of deducting expenditures which under the general rule must be capitalized.

> "A taxpayer *may* treat research and development expenditures . . . as *expenses which are not chargeable to the capital account. The expenditures so treated shall be allowed as a deduction.*" Section 174 (emphasis supplied).

Congress recognized that research and development expenditures by their nature may be capital items incurred prior to a product's commercial acceptance. To preclude the capitalizing of such expenditures and to permit their deduction when incurred, the provisions of Section 174 were fashioned. The effect of the Commissioner's "trade or business" argument is to carry us back to the state of the law prior to the enactment of Section 174.

A small business whose energies are devoted to a product development effort must begin business somewhere. If the activities of the partnership here in issue are of a nature to demonstrate commitment to a particular course of business with a profit motive and if research

and experimentation is being conducted as part of a bona fide effort to develop a particular product for use in that business, for purposes of Section 174 it should be of no concern that the partnership's efforts have not yet begun to pay off, that it has not yet found a suitable medium for exploiting the product, or that it elects to defer active sales efforts until development has been completed.

II.

The Purpose of Section 174 Would Be Served by Construing the Trade or Business Requirement to Preclude the Deductibility of Personal or Hobby Loss Items in Accordance With the Criteria Contained in Section 183.

Section 183 and the regulations thereunder indicate the type of analysis which might be invoked in the determination of whether a trade or business exists for purposes of Section 174. Section 183 provides in substance that an individual or an electing small business corporation engaged in an activity without a profit motive is not allowed deductions attributable to such activity. A presumption is provided under that section that an activity is engaged in for profit if certain requirements are met, and permits the taxpayer to postpone determination of whether such presumption applies until he has engaged in the activity for at least five taxable years. Regulation Section 1.183-2 states that the determination as to whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all the facts and circumstances of each case:

> ". . . Although a reasonable expectation of profit is not required, the facts and circumstances must

> indicate that the taxpayer entered into the activity or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent." Reg. Section 1.183-2(a).

The regulation proceeds to set forth the relevant factors to be considered in determining whether an activity is engaged in for profit. No one factor is held to be determinative. Among the factors which are said normally to be taken into account are the following:

> (1) The manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of the occasional profits, if any, which are earned; (8) the financial status of the taxpayer; (9) the elements of personal pleasure or recreation. Reg. Section 1.183-2(b).

Amici suggest that these are the factors which should be considered in determining whether a business entity's

research and experimental expenses have been incurred in connection with its trade or business for purposes of Section 174. If the entity's efforts to develop a particular product are part of a sustained effort, carried on in a business-like manner, such activities demonstrate an intent to derive a business profit and the purpose of the Section 174 trade or business requirement should be satisfied.

The court below held that it was not enough for Burns Investment Company to be engaged "in the business of doing research and experimentation, or of being an inventor", for profit. Such an interpretation of Section 174 is unnecessarily restrictive and in fact works to defeat the underlying purposes of this liberalizing provision.

The construction of Section 174 to restrict its availability to businesses engaged in the selling of goods and services has no support in the statute or legislative intent. Such a test fosters an unfortunate intrusion by the courts into the area of business decision-making as to the means and the timing of marketing operations for a business entity. Moreover, since research and development expenditures by their nature are most often incurred before a product is ready for marketing, if such expenditures cannot be deducted when incurred because of the Sixth Circuit's sales activity test, established companies (having sales activity) are favored over those entering the field with new ideas.

Good business judgment might dictate that a small company's resources be more profitably spent in product research and development during its early stages rather than being diverted into sales efforts to comply with the wooden test of the courts below. Although a new business presumably could find customers interested in acquiring a product under development on an if, as, and when developed basis, the business would be in a position of either accepting such offers to purchase the product (undoubtedly at a substantial discount) or taking the risk of running afoul of the test. As a practical result, the Sixth Circuit's test would tend to force the new business to disclose its plan to produce a new product at a time when disclosure might mean that larger firms with greater resources would appropriate the idea and be first to reach the market with the product.

It is submitted that none of the above consequences were intended by Congress in enacting Section 174 with a trade or business requirement. The liberalizing purposes of Section 174 would be served by construing the trade or business requirement to preclude the deductibility of personal or hobby items and to allow deductibility where the activities of the taxpayer are of the character as would meet the tests for deductibility under Section 183.

III.

The Sixth Circuit Was Also in Error in Denying the Benefits of Section 174 to the Partnership on the Ground That It Had No Product to Offer.

In addition to relying on the lack of marketing activity during the year in issue, the Sixth Circuit held that Burns Investment Company's research and development expenses were nondeductible because the expenditures were made when it had no product to offer. The Sixth Circuit would apparently allow the Section 174 deduction to an enterprise that has a product wholly unrelated to the new product being developed while denying the deduction to a taxpayer in business solely to market that single product.

This test produces some absurd results. For example, a company engaged in manufacturing hairpins would be able to deduct expenses incurred in developing a smogfree automobile engine while another enterprise engaged in developing this new type of engine would be denied Section 174 treatment if the engine is its initial product.

Consider also a company formed to develop a method or process for utilizing solar energy as a power source in order to eliminate dependence on oil. Such a company might build or lease a facility, purchase equipment and employ hundreds of people in research and development activities over several years before achieving the technological progress which would enable it to market inexpensive solar energy. It is inconceivable that Congress intended to withhold the benefits of Section 174 to such a company while allowing an oil company to receive the Section 174 benefits solely for the reason that the oil company has other products. The substantial advantage possessed by an established company in any field would be enhanced by preserving

for it the benefits of Section 174 while denying such benefits to a new company developing its initial product.

Section 174 should not be construed to foster or perpetuate monopoly or to preserve favored treatment for established businesses. We respectfully urge the Court to take this opportunity to formulate a trade or business test under 174 which will be sensitive to the needs of small and beginning enterprises and which will not frustrate the flow of capital to the search for new inventions and products. For these reasons it is respectfully submitted that the judgment of the Court below be reversed and the case remanded for the determination of whether Burns Investment Company meets the trade or business test as articulated by this Court.

Conclusion.

If Section 174 is to encourage research and development activities, its benefits should be available to newly-organized businesses engaged in developing new products as well as to established companies. The trade or business test under Section 174 should not be applied to discriminate against new businesses which may not yet be ready to market their initial product. The trade or business test should be applied to preclude the deduction of essentially personal or hobby expenditures under Section 183-type criteria.

Respectfully submitted,

CHARLES H. PHILLIPS,
Attorney for Amici Curiae.

February 20, 1974.

Of Counsel:
IRELL & MANELLA,
RONALD L. BLANC,
RUDOLPH R. LONCKE.